# We need to talk about Germany

**What's the matter with Germany?**

Europe and the Euro-zone have grown accustomed to facing crises; the history of the continent is filled with conflicts, crises and wars. The post-war period, albeit peaceful, has not been much different at least on an economic, monetary and philosophical level and especially so since the introduction of the common currency.

Since the end of World War II, **Germany** has been associated more with the sponsorship of the common European ideals rather than with the cause of the crises that could undermine the European project. Nonetheless, its **exploitation of the** stickiness of the common **exchange rate regime** (what's stickier than the Euro?) to the detriment of other European countries **has been flagged as one of the main causes for the weakness that has arisen in the other countries**.

Germany has been undoubtedly the juggernaut behind the European growth since the Great Recession, and before (see Figure 1), and its export-driven model of growth, although not exactly replicated by the other countries, has been a success. Others are the countries that usually bear the crux of being the profligate, over-spending and debt-burdened bad guys. Portugal, Italy, Ireland, Greece and Spain clearly spring to mind. Italy, for instance, is still in the crossfire and must fight against an ever-volatile spread between its interest rates and the German ones.

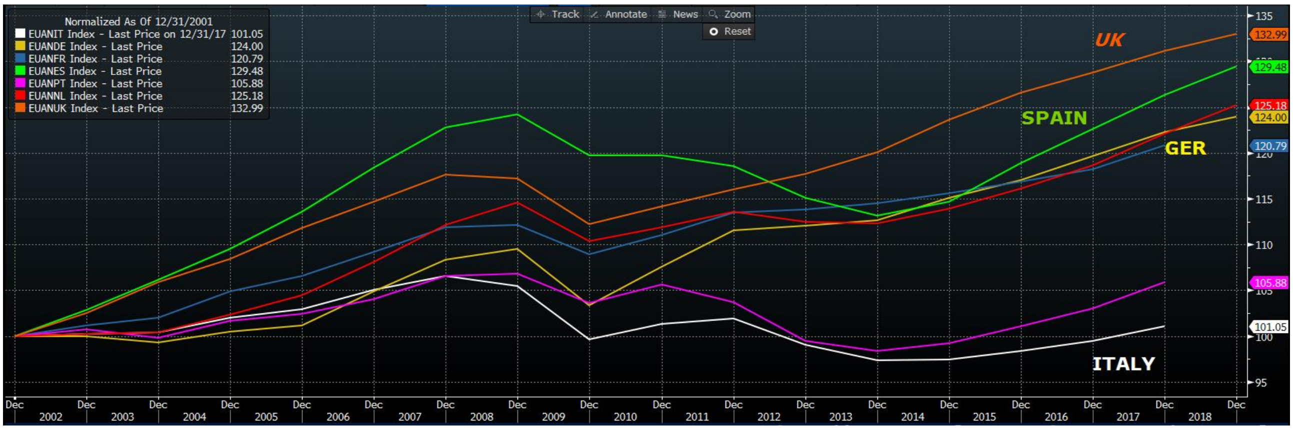

*Figure 1 Selected European countries' GDP growth since 2002. Source Bloomberg.*

But now, for the first time since long, **things are starting to look different**. It feels like the wine has finished, but we are still in the middle of the party: at first the guests share surprise and laughter, but soon disappointment and sarcasm surface and take over. And guests try to leave.

The evident changes in Europe (and not only here) are **both in social and political affairs as well as in economic ones**. With regards to the **first** point, we have witnessed the **populist backlash** which has spanned the European continent and that looks likely to stay for the foreseeable future. It has been fuelled by anti-establishment and anti-immigration sentiments and it's probably rooted in a deep realization among the masses (including, crucially, the middle classes) that we are not as rich as we thought we would be (the latest to realize it are the Gilets Jaunes in France). On the **second** point, it looks like **Germany is now heading into a recession**.

The arising of this populist wave has important repercussions. For example, it means that policies, and politics, will increasingly be focused on pushing each individual country's agenda and utility rather than thinking the best for the entire system. Whatever one thinks of Trump, it is clear that his choices and aims (from the border wall to the trade wars to the renegotiation of treaties) are going to be a blueprint for many other politicians too. This means that rather than having compromises where everyone wins and loses a bit, there will be few big winners and a lot of smaller losers.

**Economic situation**

Figure 2 shows that the **German GDP growth has now come to a halt** and certainly lower than was expected. There could have been some one-offs situations to explain it, even so, it looks like the German engine has come to an abrupt stop.

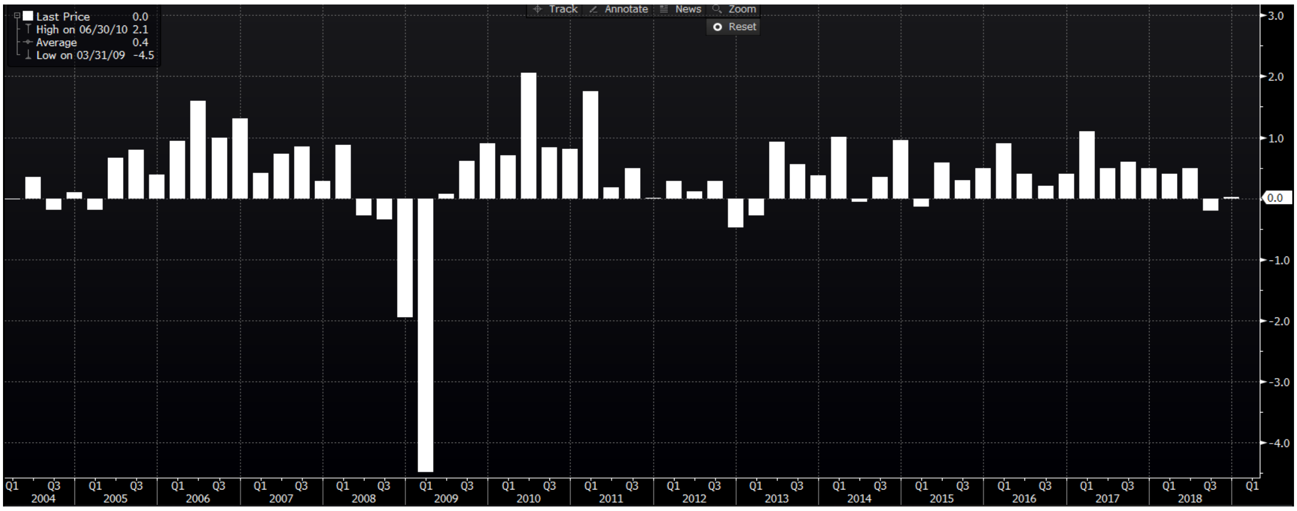


*Figure 2 Germany GDP growth QoQ SA. Source Bloomberg.*

Other pieces of hard data are in line with the overall GDP trend. In fact, **Factory Orders have shown ongoing weakness** (Figure 3) and **Industrial Production has been lacklustre** (Figure 4) for the last 6 months and has surprised decidedly on the downside for the last two.

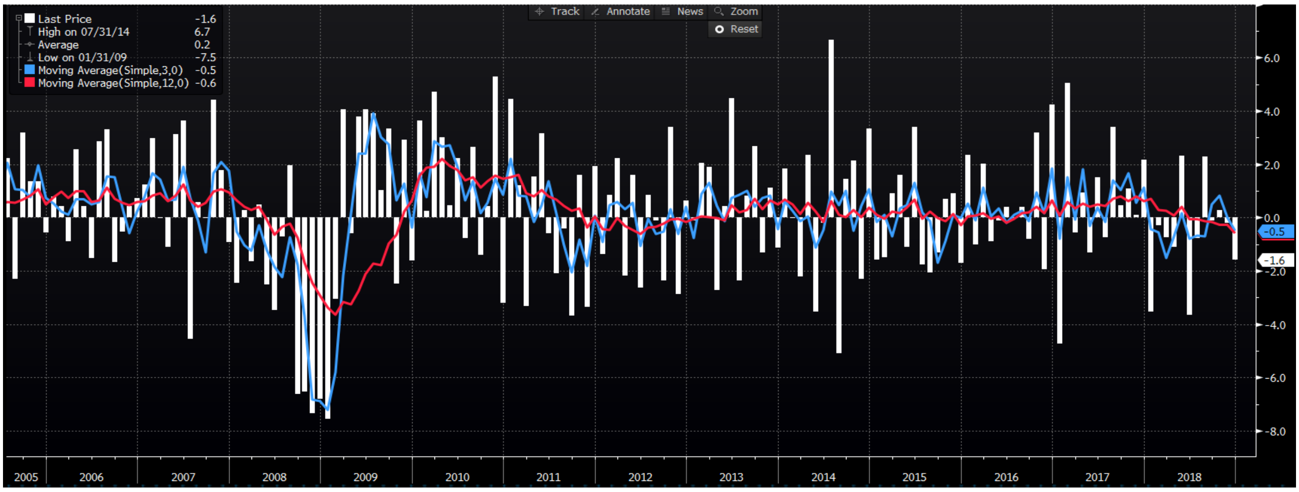


*Figure 3 Germany New Factory Orders MoM with 3m and 12m moving averages. Source Bloomberg.*


*Figure 4 Germany Industrial Production YoY NSA. Source Bloomberg.*

Additionally, leading indicators like the **PMIs** (Figure 6) **and the IFO** (Figure 7) **indexes are pointing towards further weakness**. It is interesting to see that, while the Service PMI has recently rebounded, the manufacturing index is taking an even deeper dive.


*Figure 5 IFO indexes. Green: Current Assessment, White: Business Climate, Yellow: Business Expectations. Source Bloomberg.*

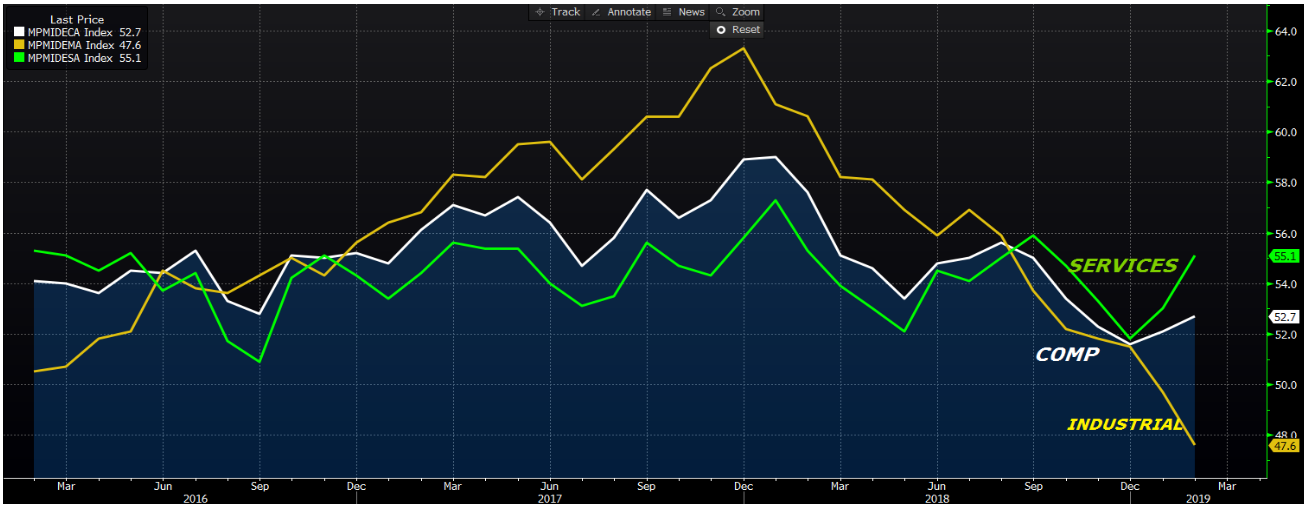


*Figure 6 Markit Germany PMIs. Source Bloomberg.*

And finally, the **Exports** (Figure 7)**, the most important part of Germany's growth, are showing signals of weakness**. Here Germany has slowed down due to shocks from foreign trade, in particular due to Trump's Trade Wars and Chinese curb on domestic credit expansion.


*Figure 7 YoY change in German Export Volumes, 3m MA[1].*

The question is if the Teutonic weakness can lead to a Eurozone, and even possibly a global slowdown in 2019.

Germany has run a fiscal surplus for years and an increasing one indeed. Germany has also usually underestimated its government revenues and under-invested in its infrastructure and military - see the US complaint at NATO level that Europe is not contributing the agreed 2% of budget to the defence spending commitments.

Hilariously, as things stand now, it seems that the bulk of the fiscal stimulus for the Eurozone is coming from France (as a reaction to the Gilets Jaunes movement) and Italy (as part of the political programme of the current government). Exactly the two countries which can least afford it, given their limited fiscal capacity - they have consistently run fiscal deficits for years and their Debt/GDP ratios are not compliant with the Maastricht treaty. Therefore potentially worsening future imbalances.

**Germany needs to consider delivering some fiscal stimulus**. It is like feeding garlic to a vampire, but probably not as deadly. German politicians fear budget deficits and policies that undermine strong exports. Nonetheless, a positive stimulus now could deliver more benefits than its costs. A stronger domestic German demand would help its trading partners (mostly European) through the Imports channel. It would also help to cushion the negative effect of Brexit, both in its soft and hard version, which is still a distinct possibility. Moreover, stronger internal demand would be valuable to offset the effects of the Trade Wars and of the possible new tariffs. True, the Trade Wars seem to be easing due to the ongoing negotiations between China and US on their new terms of engagement. Anyway, it would be foolish to think that the menace of US tariffs on European cars would go away. On the contrary, given that they worked for China, they have become more probable now for Europe as well, at least as a negotiating tactic on the US part. This is a particularly hot point, given the reliance on exports and the importance of the car industry in Germany.

[1] This chart comes from Brad W. Setser's blog "Follow the Money" at the Council on Foreign Relations, cfr.org/blog/Setser "The Case for a Significant German Stimulus Is Now Overwhelming", 11/02/2019.

Finally, Germany still enjoys high savings, low inflation and very low/negative interest rates, so the financing of the stimulus would be cheap. Furthermore, spending on internal projects and investments is usually an easy sell to the general public.

**Is Germany Europe's next nightmare?**

There has been a long debate, which still rages on, about the fact that Germany's "undervaluation regime has brought Europe on the brink of collapse"[2]. Germany, with its powerful institutions, banks, industrial conglomerates and political pressure has been able not only to impose its regime on everybody else, but also to maintain it by setting the debate in terms of ethical and moral terms of right and wrong, saint and sinners, honest and profligate – terminology that makes it easier to win debates without debating by appealing to emotions rather than rational accounting. Like it or not, the German undervaluation regime is the most nationalist policy of all because, after all, it is a beggar-thy-neighbour one and it is not used to solve any current balance of payments crisis.

The rest of the world has gone along with it because in part it could do nothing about it and in part it also benefitted by a strong Germany and its economic growth. Particularly in Europe, the widespread acceptance of the common currency, and its costs, has been supported by its perceived or promised higher benefits, for example, low interest costs, stability, positive feedback from growth in other countries, better governance of public budget and reduction of inefficiencies.

As the public opinion and political agendas have shifted, in EU as well as in US, will the acceptance of past regimes stay intact, especially if their perceived benefits disappear?

**Germany is failing to take the leading role in innovating the European Union**, by avoiding realizing that Europe can no longer live on the terms and balances of the post-war era. **Military, economically and socially Europe needs to stand on its own feet**, if it wants, together with the US, to uphold the common values of liberal democracies and if it wants to reach enough clout on its own to withstand American, Russian as well as Chinese bullying.

**Whether Germany will adapt or not is a matter of life or death for the European project: not an immediate collapse, rather a sequence of recurring crises that will take their ultimate toll on the system**. Greece in 2009: public debt crisis; Hungary since 2010: illiberal state; Italy in 2011: public budget and debt crisis; Brexit since 2016; Poland since 2017: clash with EU over democratic norms and rules; Italy again in 2018: budget deficit and veiled threats to exit the Euro - those are just the first instances of what can become a long series.

When the wine runs freely it's easy to keep everyone happy, instead when the flow stops the complaints start coming in. Germany has gained immensely from the stickiness of the system and its exchange rate undervaluation policy, now it's time to give something back if it really cares about the future of Europe.

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[2] "The German Undervaluation Regime Under Bretton Woods – How Germany became the nightmare of the World Economy", Martin Höpner, Max Planck Institute for the Study of Societies, Discussion Paper 19/1.

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